Letter Ruling 01-14: Equipment Manufactured "To be Sold"

December 14, 2001

This is in reply to your request on behalf of ********** (the "Company") for a ruling that ********** (the "Equipment") manufactured by the Company and transferred to its customers pursuant to equipment and supplies agreements are manufactured "to be sold" for purposes of the exemptions under G. L. c. 64H, §§ 6(r) and (s).[1]

STATEMENT OF FACTS

A. The Company

The Company is a Massachusetts corporation with its principal place of business in **********, Massachusetts. It manufactures the Equipment, together with certain ********** Disposables which are designed to operate interdependently with the Equipment, at its manufacturing facility in **********.[2]

The Company serves three major worldwide therapeutic markets: **********. Its customers include institutions, such as **********, as well as commercial enterprises, such as ********** (the "Customers"). The Company is a registered vendor in Massachusetts, as well as in numerous other jurisdictions.[3]

B. The Equipment and the Disposables

The Equipment and the Disposables comprise an integrated system which separates [a product] into its component parts. Briefly stated, the [product which is processed by the Equipment] is first treated with an *****, then pumped *via* plastic tubing directly into the bowl component of the Disposables which contains a specially designed spinning chamber. The centrifugal force created by operation of the Equipment is applied to the spinning chamber of the bowl and separates the various components of the [product]. The result is that the heavier [portions of the product] displace to the outer portion of the bowl, while the lighter [portions of the product] remain in the center of the bowl.

While the Disposables and the Equipment operate as one integrated unit and are necessarily transferred as such, the Disposables are purchased by the Customers, while the Equipment is transferred either pursuant to a lease agreement or, more often, pursuant to an equipment and supplies agreement.[4] The equipment and supplies agreement, which is discussed more fully in Section C. below, provides for the transfer of the Equipment to the Customer with no separately stated charge in exchange for certain contractual obligations imposed upon the Customer for the life

of the agreement.[5]

The Company does not sell the Disposables separately from transfers of the Equipment.[6] The bowls, which comprise the major component of the Disposables, operate exclusively with the Equipment, and the Equipment is designed to operate solely with the Company's bowls. The Equipment is typically operated by [state-certified professionals] who are employed by the Customers.

A significant portion of the Company's revenues are derived from contractual arrangements, such as the equipment and supplies agreement, under which the Equipment and the Disposables are transferred as an integrated system to Customers. The value of the Equipment so transferred is substantial: as of the end of the 2000 tax period, it constituted almost percent of the Company's gross United States assets.

C. The Equipment and Supplies Agreement

The Company requires each Customer who receives the Equipment to enter into an Equipment and Supplies Agreement (the "Agreement") under which the Customer is obligated to purchase exclusively from the Company for a price set forth in the Agreement all of the Disposables necessary for operation of the Equipment.[7] The Agreement states that "[The Company] has provided and is willing to provide [the Customer] with [the Equipment] and [the Customer] is willing to purchase from [the Company] exclusively all of the Disposables which are to be used with [the Equipment] at the locations in which [the Equipment] is installed."[8] The Agreement further obligates the Customer to use the Company's Equipment exclusively in its operations, thus precluding the Customer from utilizing another manufacturer's Equipment while the Agreement is in force.[9]

While the Agreement states that the Equipment is "loaned free of charge" and no separate charge is set forth specifically for the transfer of the Equipment, the Customer is bound by the terms of the Agreement as long as the Equipment remains on the Customer's premises.[10] Among the terms of the Agreement is a provision which permits the Company to remove the Equipment from the Customer's premises if the Customer fails to meet its "minimum utilization rate," a figure which is set forth in the Agreement and which requires the Customer to purchase a certain number of disposable bowls "per week per machine system wide."[11] The failure or inability of the Customer to meet the minimum utilization rate as set forth in the Agreement additionally impacts upon the Customer's ability to obtain additional Equipment in the future should it require it. In this regard, the Agreement permits the Customer to request an additional deployment of Equipment only if its specified minimum utilization rate was met over the past quarter and will continue to be met by factoring in the additional deployed Equipment.[12]

The Agreement provides for monthly and quarterly reports to be submitted by the Customer to the Company detailing the utilization of the Equipment, including downtime experienced, and the total number of procedures ***** over the course of the reporting period.[13] The reports enable the Company to determine whether the Customer has complied with the required minimum utilization rate provided in the Customer's Agreement and to track maintenance conducted on the Equipment.[14]

The Agreement states that the Customer is responsible at its own cost and expense to "keep the Equipment in good repair, condition and working order and shall furnish any and all labor required to keep the Equipment in good mechanical and working order."[15] The Agreement provides that upon installation of the Equipment on the Customer's premises, the Company will provide basic training, which includes basic repair training.[16] The Company is obligated to provide all spare parts at its own expense and to conduct annual preventative maintenance, as well as to provide on-site service assistance if the Customer cannot repair the Equipment.[17]

The Agreement further provides that if the Company markets a product which is technologically superior to the Equipment subject to the Agreement, the Company will make the new equipment available to the Customer under mutually agreeable terms.[18] Under the Agreement, "sole and exclusive" ownership of the Equipment and its component parts remains with the Company, which, at its own expense, maintains insurance on the Equipment.[19] The Company is responsible for payment of taxes other than sales, use, and excise taxes associated with the Equipment; the

Customer is responsible for transactional taxes associated with the transfer of the Equipment.[20]

Under the Agreement, the Company has the right to enter the premises of the Customer, upon reasonable notice, to inspect the Equipment and generally to observe its use by the Customer.[21] Finally, the Agreement provides that the Customer may not move the Equipment to another location or make alterations, additions or improvements to the Equipment, without the prior written consent of the Company, "which consent shall not be unreasonably withheld."[22]

RULING REQUESTED

The taxpayer requests a ruling that the Equipment manufactured by the Company and transferred to its customers pursuant to equipment and supplies agreements is manufactured "to be sold" for purposes of the exemptions under G. L. c. 64H, §§ 6(r) and (s).

DISCUSSION

A. Statutory Background

The "to be sold" requirement at issue is contained in the so-called "manufacturing" exemptions of G. L. c. 64H, §§ 6(r) and 6(s). Section 6(r) provides, in relevant part, an exemption from sales tax for "[s]ales of materials, tools, and fuel, or any substitute therefore, which . . . are consumed and used directly and exclusively. . . in an industrial plant in the actual manufacture of tangible personal property to be sold . . . ." Section 6(s) provides, in relevant part, a similar exemption from sales tax for "[s]ales of machinery, or replacement parts thereof, used directly and exclusively in an industrial plant in the actual manufacture of tangible personal property to be sold . . . ."[23]

The determination of whether the Equipment has been manufactured "to be sold" as required under §§ 6(r) and (s) depends upon whether the Equipment is treated as "sold" for purposes of G. L. c. 64H, §1.[24] Section 1 provides that the word "sale" includes: "Any transfer of title or possession, or both, exchange, barter, lease, rental, conditional or otherwise, of tangible personal property for a consideration, in any manner or by any means whatsoever."[25] Thus, under the facts presented, the "to be sold" requirement of the manufacturing exemptions will be met if "consideration, in any manner or by any means whatsoever" is present in the transfer of the Equipment to the Customer pursuant to the Agreement.

B. Appellate Tax Board Decisions

The Appellate Tax Board (the "Board") has stated in *Memorial Press* v. *Commissioner of Revenue*, 1 Mass. App. Tax Bd. Rep. 178 (1994) ("*Memorial Press*") that "[i]t is well settled that there is no special burden of proof on a taxpayer to bring itself within the 'manufacturing exemptions' to the sales and use tax provided by G. L. c. 64H §§ 6(r) and (s) and that those exemptions are not to be read restrictively."[26] The Board has been mindful in its rulings interpreting the provisions of the manufacturing exemptions of the perceived legislative purpose embodied in them, especially as it has been interpreted by the Supreme Judicial Court.[27] For example, in *Lawrence-Lynch Corporation* v. *Commissioner of Revenue*, 1 Mass. App. Tax Bd. Rep. 883 (1997) ("*Lawrence-Lynch*"), the Board stated that the manufacturing exemptions "are designed so that the [sales and use] taxes pass over the process of manufacturing products for sale."[28] The stated desire on the part of the Board to avoid the pyramiding of tax which results when successive sets of buyers and sellers, rather than the ultimate consumer, are subjected to the sales or use tax has been central to the Board's liberal interpretation of the "to be sold" requirement.[29]

In a recent case of particular relevance to the issue presented herein, *Maxymillian Technologies* v. *Commissioner of Revenue*, 1 Mass. App. Tax Bd. Rept. 132 (1999) ("*Maxymillian*"), the Board reaffirmed that its interpretation of the §1 "sale" definition in the context of the manufacturing exemptions continues to be a liberal one: "'[t]he statutory definition of sale is exceedingly broad.'"[30] Consistent with this approach, the Board refined the definitional parameters of "consideration," at least for purposes of the manufacturing exemptions, by including the common law contractual concept of consideration: "'[t]he requirement of consideration is satisfied if there is either a benefit to the promisor or a detriment to the promisee.'"[31] The Board found that the requisite

"consideration" was present in *Maxymillian, supra*, based upon the combined presence of a benefit to one party and a detriment to the other. The Board stated that "Nothing further was required to make out a 'sale' for purposes of the manufacturing exemption at issue in the case."[32]

C. "To Be Sold" Requirement Met

The Board's recent decisions as discussed above set forth the legal principles that when applied to the facts of this ruling lead to the conclusion that the various and several obligations imposed upon the Customer pursuant to the Agreement in exchange for the transfer of the Equipment constitute the requisite consideration for purposes of the "to be sold" requirement of the manufacturing exemptions. While the Agreement in "form" provides that the Equipment is "loaned free of charge" and no separately stated amount is stated for the transfer of the

Equipment, the substance of the transaction as evidenced by the terms of the Agreement and the interdependent nature of the operation of the Equipment and the Disposables comports with our conclusion that the "to be sold" requirement has been met.[33]

The transfer and retention of the Equipment is contingent upon the Customer fulfilling the minimum utilization requirements set forth in the Agreement. Further, the Customer is restricted from acquiring the Disposables from any other source, even under the circumstance in which the minimum requirements have been met. This latter requirement is a consequence not only of the terms of the Agreement, but also of the fact that the Equipment is designed to operate exclusively with the Disposables, and *vice versa*, so that the Customer's discretion in purchasing alternative sources of supplies or equipment is effectively foreclosed.

Under the Agreement, the Customer is prohibited from acquiring ***** equipment from any other source while the Equipment is on the Customer's premises. This requirement prevents the Customer from simultaneously utilizing another manufacturer's ***** equipment for the duration of the Agreement. In addition, while the Company carries insurance on the Equipment at its own expense and retains full ownership rights, the Agreement places the responsibility and expense for routine repair and upkeep of the Equipment on the Customer, with on-site service assistance from the Company if the Customer cannot repair the Equipment on its own.

Finally, the Customer is required under the Agreement to perform substantial record keeping duties to enable the Company to determine if the minimum utilization requirements are met. Further, the Company is provided under the Agreement with access, upon reasonable notice, to the Customer's premises to inspect the Equipment and to observe its use.

The restrictions and obligations imposed upon the Customer by the Agreement are clearly a detriment to the Customer since they essentially "lock in" the Customer to the Company's

products and Equipment so that the Customer acts in accordance with the best interests of the Company in generating the maximum revenue from each piece of Equipment transferred. The

Company, on the other hand, reaps the obvious financial benefits from restricting the opportunities for the Customer to seek out other sources for supplies and equipment once the Equipment is on the Customer's premises. This detriment to the Customer and benefit to the Company comprise the requisite "consideration" under the principles outlined by the Board and fulfill the "sale" requirement under §1. As a result, the "to be sold" requirement of the manufacturing exemptions is met.[34]

CONCLUSION

Based upon the facts stated and representations made in the request and accompanying materials, and for the reasons discussed above, we determine that the Equipment manufactured by the Company and transferred to its customers pursuant to equipment and supplies agreements is manufactured "to be sold" for purposes of the exemptions under G. L. c. 64H, §§ 6(r) and (s).

Very truly yours,

/s/Bernard F. Crowley, Jr.

Bernard F. Crowley, Jr.
Acting Commissioner of Revenue

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[1] The Company does not request a ruling that the other requirements of §§ 6(r) and (s) have been met.

[2] The applicability of the §§ 6(r) and (s) exemptions to the manufacture of the Disposables is not at issue in this ruling.

[3]Certain of the Company's customers are non-profit organizations which are exempt from sales tax under G. L. c. 64H, section 6(e). To the extent that its customers are non-exempt entities, the Company collects sales tax on its gross receipts from the joint transfers of the Equipment and Disposables at issue here.

[4] In certain isolated circumstances, the Company has permitted foreign-based buyers, in particular, to purchase the Equipment.

[5] Only Equipment transferred pursuant to an equipment and supplies agreement is the subject of the ruling requested herein.

[6] On occasion the Company has sold certain peripheral components of the Disposables, *e.g.,* bottles, separately from the Equipment, but the Company has represented that these transaction are not a material part of its business.

[7] The Company has provided a copy of an Equipment and Supplies Agreement which it has represented reflects the Company's current practice with regard to such Agreements entered into with its Customers. The discussion which follows is based upon the terms in the Agreement provided and cites to specific sections in that Agreement. Customers who lease the Equipment enter into a separate "Equipment Lease Agreement."

[8] "Recitals," section (vi).

[9] "Recitals," penultimate paragraph.

[10] Section 1.1 The Company has stated that the interdependent nature of the Equipment and the Disposables dictates a single stated contract price without a separate or an additional charge for the Equipment apart from that for the Disposables.

[11] Section 1.5. The structure of the minimum utilization rate is such that each piece of Equipment is expected to generate a specific minimum revenue stream for the Company.

[12] Section 1.10.1.

[13] Sections 1.10.2 and 1.10.3.

[14] See Appendix, Schedule F.

[15] Section 3.5.

[16] Section 3.2. The Agreement additionally provides for advanced maintenance repair training once per quarter at the request of the Customer and at the expense of the Company. *See* Section 3.3.

[17] Sections 1.4 and 3.5. The Agreement provides that before an on-site visit occurs, a Company "Hotline engineer" will contact the Customer by phone "within 24 hours or as soon thereafter as reasonably possible" after notification of a malfunction in the Equipment to attempt to direct the Customer in the necessary repair by telephone. Section 3.5.

[18] Section 2.6.

[19] Sections 1.8, and 8.4.

[20] Section 1.1.

[21] Section 8.7.

[22] Section 1.2.

[23] G. L. c. 64I, §7 provides that the manufacturing exemptions apply for purposes of the use tax also.

[24] See *Memorial Press* v. *Commissioner of Revenue*, 1 Mass. App. Tax Bd. Rept. 178, 182 (1994) ("*Memorial Press*") setting forth the analysis for the "to be sold" requirement in the manufacturing context.

[25] For purposes of this ruling, it is assumed without further discussion that, while title to the Equipment was not transferred, "possession" of the Equipment was transferred to the Customer pursuant to the Agreement.

[26] *Memorial Press, supra* at 181 (citations omitted).

[27] *See Wakefield Ready-Mixed Concrete Company* v. *Commissioner of Revenue*, 356 Mass. 8 (1969) and *Courier Citizen Company* v. *Commissioner of Revenue*, 358 Mass. 563 (1971).

[28] *Lawrence-Lynch, supra*, at 904-05.

[29] *See also San-Vel Corporation* v. *Commissioner of Revenue*, 1993 WL 590330 (Mass. App. Tax Bd.) ("The purpose of the [manufacturing] exemptions in question is to ensure that sales of tangible personal property are taxed only once in the production cycle, at the final stage of retail sale of tangible personal property.") More recently, the Board has included the avoidance of the pyramiding of tax in the sales and use tax area in its reasoning in a non-manufacturing context. *See TRM Copy Centers (USA) Corporation* v. *Commissioner of Revenue*, 1 Mass. App. Tax Bd. Rep. 109, 119 (2001). ("A basic consideration guiding the excise imposed at c. 64H is to 'prevent the pyramiding of taxes on successive buyers and sellers.'" (citations omitted)).

[30] *Maxymilllian, supra* at 143 (citation omitted).

[31] *Maxymillian, supra* at 144. (citations omitted). The Board ruled that the reduction in a "host community fee" otherwise payable by the taxpayer to a municipality was a benefit to the taxpayer and a detriment to the municipality which was induced to enter into the reduced-fee bargain in order to receive clean landfill from the taxpayer. The taxpayer in *Maxymillian, supra*, sought an exemption under §6(s) for a crusher machine utilized in the taxpayer's business of remediating contaminated soils as part of its manufacture of clean landfill cover. The Commissioner argued unsuccessfully that the landfill cover was not "to be sold" as required for the exemption.

[32] *Maxymillian, supra* at 145.

[33] See *J.C. Penney Company* v. *Commissioner of Revenue*, 431 Mass. 684, 688 (2000), where the Supreme Judicial Court stated in the context of the application of sales and use taxes, "It is a settled principle of our taxation jurisprudence that tax statutes are 'to be construed as imposing taxes with respect to matters of substance and not with respect to mere matters of form.'" (citations omitted).

[34] In Letter Rulings 99-8 and 00-6, we concluded that consideration was not present where a banana ripening generator and a pesticide delivery station were, respectively, "loaned" at no charge to the purchasers of the underlying pesticide, which was itself exempt from sales and use taxes under both rulings. We note that while the "form" of the transactions in these two letter rulings share some similarities with those present here, the substance of the transaction here as reflected in the detailed terms of the Agreement together with the context of the transfer of an integrated system composed of the Equipment and the Disposables provides the requisite consideration as set forth under the reasoning of the Board's rulings discussed herein. We further note that, while not necessarily determinative, neither of the earlier rulings addressed the "to be sold" requirement of the manufacturing exemption at issue here, but rather addressed the applicability of the exemption under G. L. c. 64H, § 6(p), FHH.